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IN THE

SUPREME COURT

OF THE

UNITED STATES

October Term, 1935.

Number 348

CITY OF LINCOLN, NEBRASKA, AND STANDARD ACCIDENT INSURANCE COMPANY,
PETITIONERS,
V.
L. A. RICKETTS, AS TRUSTEE IN BANKRUPTCY OF LINCOLN TRUST COMPANY, BANKRUPT,
RESPONDENT.

PETITION FOR WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

KARL W. KINDLEBERGER,
DON W. STEWART,
A. A. WHITWORTH,
CHARLES B. PAINE,
Counsel for Petitioners.

WEKESSER-BRINKMAN CO., Law Briefs, Lincoln, Neb.

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KARL W. KINDLEBERGER,
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A. A. WHITWORTH,
CHARLES B. PAINE,
Counsel for Petitioners.

To The Honorable Justices of The Supreme Court of The United States:

The petitioners, City of Lincoln, Nebraska, and Standard Accident Insurance Company, pray that a writ of cer-

tiorari be issued to review the judgment of the United States Circuit Court of Appeals for the Eighth Circuit entered in the above case on April 27, 1935, reversing the judgment of the District Court of Nebraska (R. 114).

QUESTIONS PRESENTED.

1. Whether a municipal corporation is within the provisions of Subdivision (7), Section 64b, as amended, of the Bankruptcy Act, allowing priority to:

> "debts owing to any person who by the laws of the States or the United States is entitled to priority: **Provided,** that the term 'person' as used in this section shall include corporations, the United States and the several States and Territories of the United States."

2. Whether a trust relation existed under the terms of a writing which provided that a trust company "* * * holds for investment in trust, funds belonging to City * * *."

3. Whether a trust company, by accepting public funds under circumstances making such acceptance illegal, thereby became a trustee ex maleficio.

4. Whether the rule under the Constitution and statutes of Nebraska, that claims for trust funds should be given priority if such funds augmented the assets of the trustee, should be followed by the federal courts.

STATUTE INVOLVED.

The Bankruptcy Act (C. 406, Sec. 15, 44 Stat. 666, 11 U. S. C. A., Sec. 104b), provides in part as follows:

> "The debts to have priority in advance of the payment of dividends to creditors and to be paid in full out of the bankrupt estates and the order of payment shall be * * * (7) debts owing to any person who by the laws of the states or the United

States is entitled to priority; provided, that the term 'person' as used in this section shall include corporations, the United States and the several states and territories of the United States."

STATEMENT.

Petitioners' claim to a priority in the payment of the claim of the City of Lincoln in the amount of $45,509.00 against the Lincoln Trust Company, Bankrupt, was denied (R. 114).

There is practically no dispute as to the facts and most of them are covered by a stipulation (R. 68). In substance it is shown by the stipulation that the City of Lincoln, Nebraska, a municipal corporation, paid to the Lincoln Trust Company, sometimes referred to as the "Bankrupt", the sum of $45,000.00. At that time the Bankrupt was engaged in conducting a general trust company business under the laws of Nebraska with its place of business at Lincoln, Nebraska. Upon receiving such money the Bankrupt delivered to the City nine certificates for $5,000.00 each which were identical except each bore a different number. The following is a copy of one of the certificates (R. 68):

"No. Lincoln, Nebraska, Sept. 26, 1928 No.....

"THIS IS TO CERTIFY that the LINCOLN TRUST COMPANY of Lincoln, Nebraska, holds for investment in Trust, funds belonging to City Treasurer of Lincoln, Nebraska, in the sum of Five Thousand & no/100 Dollars ($5,000.00) with interest at 3 per cent per annum payable quarterly from date until returnable to owner on demand 19.....

"This Trust Certificate bears no per cent interest after maturity.

LINCOLN TRUST COMPANY
By (S.) Howard Hadley, Secretary."

The $45,000.00 was placed by the Bankrupt in its general fund and the following entry was made on a ledger sheet of the bankrupt (R. 68):

"Trust Certificate	City Treasurer of Lincoln	Credit	Balance
10-1-28	By 160-162 to 169 inclusive $5000.00 each at 3% on demand	45,000.00	45,000.00"

Thereafter the Bankrupt paid interest to the City at the rate of 3 per cent per annum up to March 26, 1932. No further interest was paid nor has the principal ever been paid (R. 69). The trust certificates issued to the City together with other trust certificates outstanding amounted at that time to approximately $64,000.00 (R. 71). At the time the City paid the $45,000.00 the Bankrupt had no separate bank account for its trust department, but on October 3, 1931, it created a trust department bank account by depositing in a special account in a Lincoln, Nebraska, bank $49,679.17, which amount was withdrawn from its general account with the same bank. This deposit included all trust funds held by the Bankrupt except the fund held for the City, which was not included because the Bankrupt did not have sufficient funds (R. 71). The transfer did not reduce its cash on hand below the amount set forth in the next paragraph (R. 72).

On June 14, 1932, the City demanded the principal and accrued interest on its certificates which was refused by the Bankrupt (R. 73). Up to that time the lowest balance of cash in its general bank account was $7875.97 on May 13, 1932, and on that same date Bankrupt had in addition thereto cash items of $5193.45 (R. 72).

On June 15, 1932, the day following the City's demand, the Bankrupt took from its general account $44,982.46

and transferred it to the trust department of the trust company where it was set up on the trust department books as "Segregated Assets".

The amount of this fund was equal to the amount of payments made after April 7, 1932, by certain borrowers and mortgagors owing money to the Lincoln Trust Company (R. 80) plus the amount received by the Lincoln Trust Company after April 7, 1932, from certain customers under the terms of certain Eltelic contracts between the Trust Company and its customers whereby the Trust Company agreed to pay from its own funds premiums due on insurance policies held by the customers (R. 75-78). While no special items of liability were set up against the fund segregated when it was transferred to the trust department (R. 72) it appears that the purpose was to enable the Lincoln Trust Company to pay from this special fund indebtedness owed by it to insurance companies for premiums and to persons purchasing bonds from it evidencing a partial interest in the mortgages upon which payments were made and there has been no claim filed with the Receiver by either the bondholders or by the insurance companies to which premiums were owed or by the persons making said payments, asserting that the amounts so paid were held in trust by the Bankrupt as disclosed by the record in this case and it must be assumed, and we contend the fact to be that the segregation of this amount was for the benefit of general creditors of the bankrupt (R. 72-80). The lowest balance in that account from the time it was created until the trust company closed was $25,097.09, on the day it closed and this amount was turned over to the receiver in bankruptcy and then by the receiver to the trustee in bankruptcy (R. 72).

The assets in the trust department, exclusive of the segregated assets account, were sufficient to take care of all liabilities of the trust department, not, of course, including the claim of the City (R. 72).

The Bankrupt had on deposit with the Department of Trade & Commerce of the State of Nebraska when it closed, securities in the principal sum of $47,000.00 which were held as required by the provisions of Section 8-209, C. S. of Nebr. 1929, for the payment of trust liabilities of the Bankrupt (R. 69).

The City filed a general claim against the Bankrupt for $45,509.00 (R. 5) which was allowed the day it was filed (R. 8). Subsequently the City was given leave to file an amended claim seeking priority in the payment of its claim (R. 10). An amended claim was filed (R. 10). Appellee filed objections to the allowance of any priority (R. 14).

On December 10, 1933, a hearing was held on the City's claim of priority and the matter was thereafter submitted to the Referee on written briefs of the parties (R. 66). On February 6, 1934, the right to priority not yet having been determined by the Referee, the appellee asked leave to withdraw its submission of the case, to file additional objections to the claim, and to offer further evidence in support thereof showing that the Standard Accident Insurance Company had paid to the City the amount of its claim (R. 16). The Referee granted the appellee's application and thereupon a stipulation was filed setting forth the fact that Bankrupt, as principal, and said insurance company, as surety, had executed and delivered to the City a bond wherein it was agreed that the aforesaid $45,000.00 should be repaid to the City upon its demand. The stipulation further set forth the payment to the City by said insurance company of the amount

of its claim and an assignment by the City to the insurance company of its rights, including its claim and the amended claim (R. 19). The Referee received the foregoing stipulation in evidence and thereupon the insurance company was made a party to the proceedings and is one of the petitioners herein (R. 21).

Ruling of the Courts Below.

On April 13, 1934, the Referee entered an order disallowing the claim of priority and directing that the claim should stand allowed as a general claim (R. 22).

Petition for review was filed and submitted to Hon. J. A. Donohoe, District Judge (R. 28). On October 8, 1934, a memorandum was filed by the District Judge in which he held that the claim was entitled to priority in the sum of $12,979.42 (R. 39).

On December 12, 1934, the District Judge, without notice, withdrew his memorandum of October 8th and filed a new memorandum allowing priority of only $628.63 (R. 40-57).

On December 17, 1934, judgment and decree was entered directing that the Referee's order disallowing priority be modified by allowing priority to the extent of $628.63 to be paid prior to the claim of general creditors and the balance to be allowed as a general claim (R. 59).

On April 27, 1935, the Circuit Court of Appeals modified the judgment of the District Court by disallowing any claim of priority (R. 114).

On May 25, 1935, a petition for rehearing was filed by petitioners (R. 125) which was denied on July 3, 1935 (R. 127).

Reasons Relied Upon for the Allowance of the Writ.

1. The decision of the Circuit Court of Appeals has decided an important question of federal law which has not been passed upon by the Supreme Court, in construing Section 64b (7) of the Bankruptcy Act to deny a municipal corporation the same right of priority as is given other corporations.

The construction of the Bankruptcy Act on the foregoing point has never been directly passed upon by the Supreme Court although a similar question was before the Supreme Court in the case of *Davis* v. *Pringle*, 268 U. S. 315, wherein the court held that the United States was not given priority under Section 64b as it existed prior to the 1926 amendment. The particular rule laid down has been abrogated by the 1926 amendment to the Bankruptcy Act.

2. The decision of the Circuit Court of Appeals in holding that no trust relation existed under the terms of a writing providing that a trust company "* * * holds for investment in trust, funds belonging to City * * *" has decided an important question of general law in a way untenable and in conflict with the weight of authority.

3. The decision of the Circuit Court of Appeals in holding that a trust ex maleficio did not result has decided an important question of general law in a way untenable and in conflict with the weight of authority.

4. The decision of the Circuit Court of Appeals in refusing to follow the construction by the Supreme Court of the Nebraska Constitution and statute relating to trust funds has decided a federal question and an important

question of general law in conflict with the weight of authority and with applicable decisions of the Supreme Court of United States.

The decision is contrary in principle to the rule announced by the Supreme Court of United States in *Burns Mortgage Co.* v. *Fried*, 292 U. S. 487, and *Marine Nat'l. Exch. Bank* v. *Kalt-Zimmers*, 293 U. S. 540, declaring that the federal court must adhere to the state court's construction of its law even though such law only purports to be declaratory of the common law.

For these reasons it is respectfully submitted that this petition should be granted.

CITY OF LINCOLN, NEBRASKA, AND STANDARD ACCIDENT INSURANCE COMPANY,
Petitioners,

By KARL W. KINDLEBERGER,
DON W. STEWART,
A. A. WHITWORTH,
CHARLES B. PAINE,
Counsel for Petitioners.

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BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I.

OPINIONS.

The opinion of the Circuit Court of Appeals, Eighth Circuit, filed April 27, 1935, is reported in 77 Fed (2d) 425, and is in the record (R. 116).

II.

JURISDICTION.

Judgment of the Circuit Court of Appeals was entered April 27, 1935 (R. 114). Petition for rehearing was denied July 3, 1935 (R. 127). Jurisdiction of this court to issue the writ applied for, is invoked under Section 240 (a), Judicial Code, as amended by the Act of February 13, 1925 (C. 229, Sec. 1, 43 Stat. 938, 28 U. S. C. A., Sec. 347).

III.

STATEMENT OF THE CASE.

The statements of the matters involved, already given in the petition, pages 3 to 9, contain all that is material to the consideration of the questions presented.

Briefly summarized, the evidence shows that on September 26, 1928, the City of Lincoln, Nebraska, a municipal corporation, paid $45,000.00 to the Lincoln Trust Company, then engaged in a general trust company business, under the laws of Nebraska. The Trust Company upon receiving such money delivered to the City nine certificates for $5,000.00 each, the material parts of which are as follows:

> "THIS IS TO CERTIFY that the LINCOLN TRUST COMPANY of Lincoln, Nebraska, holds for investment in Trust, funds belonging to City Treasurer of Lincoln, Nebraska, in the sum of Five Thousand & no/100 Dollars ($5,000.00) with interest at 3 per cent per annum payable quarterly from date until returnable to owner on demand 19——"

The Trust Company paid the City interest at 3 per cent up to March 26, 1932. The $45,000.00 was placed by the Trust Company in its general bank account. On June 14, 1932, the City demanded the principal and

accrued interest on the certificates, which was refused. Up to that time the lowest balance of cash in its general bank account was $7,875.97 and cash items of $5,193.45. On June 15, 1932, the Trust Company transferred from its general bank account $44,983.46 to its trust department, which it designated as "Segregated Assets Account" but no special items of liability were set up against that fund. The lowest balance in that account up to the closing of the Trust Company was $25,097.09 on the day it closed, which was turned over to the trustee in bankruptcy.

The City filed a general claim for $45,509.00 which it subsequently amended to claim priority. After the question of priority was submitted to the Referee the petitioner, Standard Accident Insurance Company as surety for the Trust Company, paid to the City the amount of its amended claim. The City's rights were then assigned to the insurance company, which was thereupon made a party to the proceedings.

The reasons relied on for the allowance of the writ show the errors intended to be urged and for brevity they are not repeated at this point.

IV.

SUMMARY OF ARGUMENT.

1.

The Circuit Court of Appeals erroneously construed Section 64 (b) of the Bankruptcy Act to deny a municipal corporation the same right of priority given to other corporations.

2.

The Circuit Court of Appeals erroneously holds no trust relation existed under the terms of the writing which provided that the Trust Company "* * * holds for investment in Trust, funds belonging to the City * * *."

3.

The Circuit Court of Appeals erroneously held that a trust ex maleficio did not result if a trust company received money as a deposit which it had no right to so receive.

4.

The Circuit Court of Appeals erroneously refused to follow the construction by the Supreme Court of Nebraska of the Nebraska Constitution and statute that trust funds may be recovered from an insolvent trustee upon proof that such funds augmented the assets in the hands of such trustee.

ARGUMENT.

1.

The Circuit Court of Appeals erroneously construed Section 64 (b) of the Bankruptcy Act to deny a municipal corporation the same right of priority given to other corporations.

Section (7) of 64 (b) of the Bankruptcy Act, as amended (11 U. S. C. A. Sec. 104b), provides:

> "The debts to have priority in advance of the payment of dividends to creditors and to be paid in full out of the bankrupt estates and the order of payment shall be * * * (7) debts owing to any person who by the laws of the states or the United States is entitled to priority: provided, that the term 'person'

as used in this section shall include corporations, the United States and the several states and territories of the United States."

The City claimed the right of priority accorded a sovereign at common law (see *Marshall* v. *N. Y.*, 254 U. S. 380-382), under the provisions of Section (7) of 64 (b) quoted above and Section 49-101, C. S. of Nebr. 1929, which provides:

> "**Common Law in Force.** So much of the common law of England as is applicable and not inconsistent with the Constitution of the United States, with the organic law of this state, or with any law passed or to be passed by the legislature of this state, is adopted and declared to be law within the state of Nebraska (R. S. p. 31; Ann. 6955; Comp. 1934; R. S. 1913, 3697; C. S. 1922, 3085)."

The Circuit Court of Appeals in recognizing this general right of the City to such priority says:

> "It is earnestly urged that by right of sovereignty, the City is entitled to priority in the payment of its claim. At common law, the Crown had a priority over all subjects for the payment of debts due it. In a receivership case arising in a state where the common law prevailed without statutory modification, and where the Supreme Court of the State had not theretofore passed upon the question, we held that such prerogative right inhered in a city as an agency of the state exercising a delegated sovereignty. *City and County of Denver* v. *Stenger*, (C. C. A. 8) 295 Fed. 809."

However, the Circuit Court of Appeals construes Section 64 (b) of the Bankruptcy Act, quoted above, to deny a municipal corporation the right of priority given to other corporations as well as persons. In discussing this question the opinion says:

"It is contended that this section of the bankruptcy act preserves the City's right as a sovereign to priority in payment of its debt in the provision that 'debts owing to any person who by the laws of the States or the United States is entitled to priority.' It is observed that the statute defines the scope to be given to the term 'person', it being provided that it shall include 'corporations, the United States and the several States and Territories of the United States.' It makes no mention of municipalities, counties, or other sub visions of the Government, and hence, we think they are necessarily excluded."

The Circuit Court of Appeals has either misconstrued or has failed to properly apply the principal announced in *Davis* v. *Pringle*, 268 U. S. 315, quoted in part in the opinion (R. 123), and further its construction of the bankruptcy act fails to give effect to the intent of Congress as expressed by the 1926 Amendment passed subsequent to the decision of *Davis* v. *Pringle*.

Justice Holmes denies priority to the United States because other parts of the Bankruptcy Act in giving it priority specifically mention it by name and he therefore concludes that the United States was not intended to be included in the word "person". On this point Justice Holmes says:

"It is incredible that after the conspicuous mention of the United States in the first place at the beginning of the section and the grant of a limited priority, Congress should have intended to smuggle in a general preference by muffled words at the end."

But a different situation exists as to a municipal corporation. It will be observed that in other parts of the Bankruptcy Act it treats a municipal corporation as in-

cluded within the general designation "corporation" and where it is desired to exclude municipal corporations it is mentioned as a specific exception to "corporations".

The corollary of the principle announced in *Davis* v. *Pringle, supra,* is that where in some instances a law specifically excepts a special class from a general class the use of the word describing the general class without the exception clearly shows an intention to treat the special class as covered by the words used to describe the general class. In other words, an examination of the entire Bankruptcy Act shows it intends to include municipal corporations within the designation "corporations" or "persons" unless specifically excepted. But as to the United States, it is not included in any other words and where covered by any provision, it is specifically mentioned.

The portions of the Bankruptcy Act excepting municipal corporations from the general designation "person" or "corporation", will be mentioned here for the convenience of the court.

Section 4a of the Bankruptcy Act, 11 U. S. C. A., Sec. 22:

> "Any **person** except a **municipal,** railroad, insurance, or banking **corporation** shall be entitled to the benefits of this title as a voluntary bankrupt."

Section 4b of the Bankruptcy Act, 11 U. S. C. A., Sec. 22:

> "* * * **any moneyed, business or commercial** corporation, **except a municipal,** railroad, insurance, or banking **corporation** * * *."

Section 64a of the Bankruptcy Act, 11 U. S. C. A., Sec. 104a:

> "The court shall order the trustee to pay all taxes legally due and owing by the bankrupt to the United States, state, county, district or municipality, * * *."

The use of the word "municipality" in the section just quoted does not militate against the argument heretofore made. It is obvious that the word "corporation" would be inappropriate to use in this part of the law because taxes are not payable to corporations generally, but only to governmental agencies, which it will be observed are specifically described.

We submit that the rule announced in *Davis* v. *Pringle,* is not applicable to exclude municipal corporations in view of the specific provisions of the Bankruptcy Act and that municipal corporations either as "persons" or as "corporations" were given priority in the law before the 1926 amendment.

That amendment strengthens this construction. It shows the intention to have the word "person" include not only the United States but also the states, territories and corporations generally. The purpose is manifest to include within the word "person" substantially every class of creditor. Certainly a municipal corporation was included because not excepted from the general word "corporation" as is done elsewhere in the Act. A municipality is a mere subdivision agency, or part of the state. The intention to include states within the term persons is clearly expressed and a forced and unnatural construction must be placed upon the act to exclude parts thereof where no logical ground for distinction exists.

Our contention as to the intent and construction of the 1926 amendment is supported by James Angell McLaughlin's article in the Harvard Law Review, Volume 40, pages 345 and 346. In discussing the amendment he says:

"The rule of *Davis* v. *Pringle* is reversed, and the United States and the states are expressly declared to be 'persons' which may have priority in bankruptcy on claims other than taxes in accordance with other federal or state laws. Such priority remains of a deferred class—that immediately preceding the claims of creditors to dividends.

"It has been pointed out that litigation may arise by reason of the fact that it is not expressly declared that counties, districts or municipalities are entitled to such priority on claims other than taxes. This is in contrast to the language of Section 64 (a) which specifies that taxes owing to 'the United States, state, county, district or municipality' shall have the next preceding degree of priority. The argument will be made that such governmental units are by implication denied priority on other than tax claims even when it is granted them by state law. **As applied to municipal corporations such an argument should not prevail.** *Davis* v. *Pringle* was a case of priority claimed by the United States. The argument for the government upon the act as it stood was this. Section 64 (b) gives persons priority in accordance with the laws of the United States. The United States is a corporation, a corporation is a person as defined in Section 1 (19), and is entitled to priority by reason of Section 3466 of the Revised Statutes. The Supreme Court thought that Congress would, if it intended the United States to have the claimed priority in bankruptcy, have provided for it by direct expression instead of through such a 'logical concatenation.' Shortly before the Act of 1926, the decision had been interpreted to exclude a state from priority provided by the state law. **The amendment in repudiating *Davis* v. *Pringle* as applied both to its own facts and to state priorities would seem to be a repudiation of the reasoning on which that case is based. A municipal corporation is clearly a person within the Bankruptcy Act not only because the definition of a person covers it, but**

> **because it is expressly referred to as a person in Section 4 (a). Furthermore there is less reason to apply the rule of *Davis* v. *Pringle* to a state or a municipal corporation than to the United States.** If Congress meant the United States to have a priority, it could easily have said so. There has never been even a suggestion that Congress should set up a priority for states or municipalities that the states would not claim for themselves or establish for the benefit of their municipalities. **With reference to these, the natural thing was simply to allow them to be covered by a general clause recognizing priorities established by state law."**

The reasoning in the foregoing article by Professor McLaughlin of the Harvard Law School is logical and the construction which he places on this amendment, if followed, would give the City the priority of a sovereign to which it is entitled under the laws of Nebraska.

2.

The Circuit Court of Appeals erroneously holds no trust relation existed under the terms of the writing which provided that the Trust Company "holds for investment in trust, funds belonging to the City."

The certificate delivered by the Trust Company to the City is set forth in full at page 3 hereof. In substance it states that the Trust Company "* * * holds for investment in trust, funds belonging to City * * *" amounting to $45,000.00 "with interest at 3 per cent per annum payable quarterly from date until returnable to owner on demand 19____ This Trust Certificate bears no per cent interest after maturity."

The Circuit Court of Appeals' opinion holds no trust relation existed under this writing, principally because

the payment of interest by the Trust Company to the City indicated the funds were to become the property of the Trust Company and because such funds were to be repaid by the Trust Company in cash. The decision on this important question of general law is probably untenable and in conflict with the weight of authority.

In the first place, the writing itself shows the parties contemplated a trust relation. It states the Trust Company "holds for investment in Trust, funds belonging to City." Every word just quoted implies the funds were to remain the City's property and simply to be held in trust for the City. Words could hardly be more conclusive in their meaning. Furthermore, the intention of the parties at the time the payment was made controls. See *Northern Sugar Corp.* v. *Thompson,* 13 Fed. (2d) 829 (C. C. A. 8), and *Keyes* v. *Paducah & I. R. Co.,* 61 Fed. (2d) 611 (C. C. A. 6).

It is true payment of interest may ordinarily imply a loan, but is not conclusive that a loan was made. In the case of *In re Newark Shoe Stores,* 3 Fed. Supp. 293 (Md.), deposits were made by store managers as a condition precedent to their employment and the store agreed to pay interest thereon annually. The store mingled the funds with its own funds and never kept a separate account thereof. Upon the bankruptcy of the store the managers claimed their funds were held in trust and the court upheld their contention. In discussing the question of the payment of interest it is said in the opinion:

> "First, with respect to whether the deposit of the guaranty fund created a trust or something in the nature of a trust, it is too well settled to require citation of authorities that there can be no trust if there is no intention to create one, and, further, the fact that interest at a fixed rate is stipulated to be paid upon a deposit is prima facie, **but not neces-**

> sarily, **conclusive evidence** that the transaction is a loan, namely, that the relationship of debtor and creditor, and not that of trustee and cestuis que trust, is created."

It is significant that there is not a single word in the agreement of the parties in the foregoing case indicating a trust relation was intended. In the present case the agreement entered into between the City and Trust Company, whose very business was to act as a fiduciary, expressly stated that the Trust Company "holds for investment in Trust, funds belonging to City". No words could make it plainer that the parties intended to create a trust and it is a fundamental rule that where there is a written agreement, it is always the best evidence of the intention of the parties.

In the recent case of *In re Whitty*, 175 Atl. 871 (Pa.), the record shows a trust company received funds for investment and guaranteed a return of 5 per cent interest thereon, the excess to be retained by the trust company. The agreement was recognized as an enforceable trust.

In *Gerard* v. *Bank of N. Y.*, 240 App. Div. 531, 270 N. Y. S. 835, an agreement called a "Trust of Accumulation" acknowledged the receipt of funds to be held in trust, the trust company agreeing to pay compound interest at the rate of 5 per cent per annum. The agreement was recognized as an enforceable trust.

In the case of *In re Roberts*, 175 Atl. 869 (Pa.), the trust company received cash in trust and agreed to invest it in legal investments but also agreed to repay the principal of the trust **in cash** upon thirty days' notice. It was held the agreement was a valid trust and required the repayment of the trust principal in cash.

The cases just cited indicate that the agreement to pay interest does not show conclusively that no trust agreement was created and likewise that the promise to repay the principal in cash does not necessarily show that no trust relation existed. It would seem that the intention of the parties to create a trust relation, as clearly shown by the writing, should control.

The case of *City Council of Charleston* v. *Elliott*, 73 Fed. (2d) 920 (C. C. A. 4), cited in the opinion does not support the holding that no trust relation existed. In that case it is stated there was nothing to show: "* * * that the bank should handle them as trust funds held by it as a fiduciary." In that case there was merely a deposit in a commercial bank, whereas in the present case there is a specific agreement that the funds are held by a trust company in trust.

The statement is made in the opinion (R. 121) as follows:

> "Even though the money was paid with the thought of a possible future investment, this special purpose does not in itself give rise to a trust relation."

Several cases are cited in support of the above quotation, but it is significant that the rule stated in each of these cases actually supports the contention of the petitioners that a trust relationship exists in this case. We call attention particularly to the first case cited of *Blakey* v. *Brinson*, 286 U. S. 254, 76 L. Ed. 1089, where it is said in the opinion, on page 262:

> "* * * if the respondent had handed the money back to the bank **under a specific agreement between him and the bank that the money was to be held as a special fund, * * * such a procedure, if actually carried out, might afford a**

> **basis,** which is lacking here, for the inference **that respondent,** no longer content with the role of creditor, **had sought to establish a trust fund."**

In the present case the City did pay money to the Trust Company "under a specific agreement * * * that the money was to be held as a special fund" for the purpose of investment and this, under the quotation above, would infer the establishment of a trust fund.

3.

The Circuit Court of Appeals erroneously held that the receipt of the City's funds by the Trust Company, although not as an express trust, was nevertheless rightful and that consequently a trust ex maleficio did not result in favor of the City of Lincoln.

If a trust relation did not arise from the agreement of the parties, then we contend a trust ex malificio resulted and that the decision of the Circuit Court of Appeals in refusing to so hold, decided an important question of general law in a way untenable and in conflict with the weight of authority.

The Circuit Court of Appeals in holding to the contrary based its decision on two reasons. The first is that the City of Lincoln, due to its participation in making the deposit was prevented from raising any question regarding the illegal nature of the arrangements made in that it did not come before the court with clean hands. This is set out in the opinion (R. 122) as follows:

> "It (the city) is hardly in position to come into a court of equity repudiating or casting aspersions upon the transaction. It must come into court with clean hands."

The opinion places an unjustified construction on the evidence. There is nothing to indicate that the City did not come into court with "clean hands". It paid the Trust Company its money and received a writing which on its face indicated clearly an intention of the parties that the funds should be held in trust. It still claims that the funds are held in trust under its agreement, but in addition it claims that if the agreement does not create a trust relation, then the court should find that a trust resulted from the transaction in favor of the public.

The court has overlooked the fact that the wrongful acts, if an express trust was not created, were committed by the Bankrupt in receiving the fund illegally and by the city treasurer and that the public is not bound thereby. To hold that a public body is estopped from raising the question of illegality, due to its participation in the arrangement for the deposit merely to the extent that its funds are used by its treasurer in making the deposit, would in every case of a claim of the nature asserted herein, result in a denial of the relief asked. Authority to the contrary is overwhelming. It is universally conceded that the illegal or wrongful deposit of public funds gives rise to a trust ex malificio. This rule is stated in the annotation in 51 A. L. R., at page 1342, as follows:

> "It is a principle supported by numerous authorities that the unauthorized or unlawful deposit of public funds in a bank which subsequently becomes insolvent creates a trust relationship in such funds between the bank and the community to which they belong. It is obvious that to hold otherwise in such cases would leave an open door to fraud, and would allow the interests of the public to be jeopardized by the wrongful act of a trusted officer."

Both United States and Nebraska cases are cited in support of this rule.

In every case where courts have held that a trust ex malificio resulted in favor of a public body, that body has participated in the arrangements for the deposit to at least the extent that the City of Lincoln participated in this case, namely, that public funds were used in making the deposit. And in many cases the participation has been greater, due to the fact that the governing authorities of the public bodies gave directions to the depositing officer which in some manner did not comply with the applicable law. The well established rule of law that a municipal corporation is not estopped by the acts of its officers from asserting the illegality of a transaction is applicable to the present case in view of which we submit that there can be no serious question of the right of the City of Lincoln to show that if the agreement did not create a trust relationship, any other construction placed thereon, would result in an illegal transfer of the City's funds, and consequently give rise to a trust ex maleficio.

The more important question is whether under all the circumstances of this case the deposit of the City's funds was illegal if a trust was not expressly created. The Circuit Court of Appeals only briefly considers the question in view of its holding that the City is estopped from raising the question. The second reason for the disallowance of the claim is stated (R. 121) as follows:

> "But it is urged by the appellant Insurance Company that if the money was paid to the Trust Company as a deposit then it became a trustee ex maleficio, because, it had no right to accept deposits. The Trust Company in this transaction was not in the banking sense of the word receiving deposits, but we are of the view that the transaction resulted in the creation of the relation of debtor or creditor."

We believe it is conceded that if the City's money was accepted by the Trust Company as a deposit, that its acceptance thereof was illegal, in view of the limitations placed upon its power, under the statute under which its charter was granted (Secs. 8-201 to 8-221, C. S. of Neb. 1929). A trust company so organized in Nebraska has no authority to transact a banking business. The powers thereof were considered and the statute above cited construed in the case of *Gamble* v. *Daniel*, 39 Fed. (2d) 447 (C. C. A. 8), and it was there held that a trust company so chartered has authority to accept deposits only "to conduct safety deposit vaults and to act as a depository for money in court." The evidence is undisputed in this case that the City's money was not received by the Trust Company for either of these purposes. It seems obvious therefore that if it was accepted as a deposit in any other sense that the transaction was unlawful.

It becomes necessary then to examine the transaction to determine what possible construction can be placed thereon other than that the money was received in trust. These possibilities are limited only by the possible legal consequences arising when one individual pays or delivers money to another.

However, any relationship created will fall into either of two classes, the first in which title to the fund delivered passes and the second in which the title to the fund or its proceeds is retained by the transferor. Any construction placing the particular transaction in the second class will result in the allowance of the City's claim and since we only contend that a trust was created it is unnecessary to further discuss these possibilities.

We submit that the only reasonable interpretations to the effect that the transaction falls into the first class are

that the acts constitute an attempt on the part of the Bankrupt and the city treasurer to create a bank deposit or an attempt by the Bankrupt to borrow public funds for its private use from the city treasurer. In either case the relationship attempted would be that of debtor-creditor and the Circuit Court of Appeals in stating that this was the result of the transaction made no answer to the City's contention that the transaction was illegal. It merely points out the general class of relationships into which, bank-depositor, lender-lendee relationships fall.

It is true that the relationship of debtor or creditor between the Bankrupt and City might have arisen under certain legal circumstances, but this does not justify the court in finding that all circumstances giving rise to a debtor-creditor relationship between these parties would be legal circumstances from which no other consequences except those normal to the relationship would flow. But if the statement of the Circuit Court of Appeals is to be taken as a reason this meaning must be given to it.

We submit that if the certificates do not evidence an intent that the fund should be held in trust, that they evidence an intent to create a debtor-creditor relationship, unlawful and illegal in its nature and that consequently the court should not permit the normal consequences to follow, but should under general principles impress the fund with a trust ex malificio.

If these certificates, due to an apparent repugnacy in their provisions, do not create an express trust, the most reasonable construction of the debtor-creditor class is that they were certificates of deposit payable on demand and of the same nature as commonly used in banking transactions as distinct from certificates of deposits covering bailment or other business transactions. The similarities between the instruments in question and an ordi-

nary bank certificate of deposit are so apparent that enumeration thereof is unnecessary. If "hold for investment in trust, funds of" is not given any meaning, then these instruments are identical with an ordinary bank certificate of deposit which merely certifies that a named individual has on deposit with the issuing bank a sum certain payable on demand or otherwise.

While it is possible as pointed out above that the certificate may show an intent on the part of the treasurer to loan funds of the City to the Lincoln Trust Company, that is to loan public funds for private use, we submit that such an interpretation is unnatural, for with the exception that the certificates are in a definite amount, are dated, and contain a provision for the payment of interest, these certificates have none of the characteristics of promissory notes. The particular characteristics are common to many ordinary business contracts, but the certificates do not contain the one most essential characteristic of a promissory note, namely, an express promise to pay a sum certain in money. The promise in the certificate must be implied, as it is implied in many certificate of deposit forms, but not in note forms. If there was an intent to create a lender-lendee relationship how much easier it would have been to evidence such an intent by the use of ordinary note forms, undoubtedly in the possession of the Trust Company since it was in a business making the use of ordinary note forms a common occurrence.

There is nothing in the record explaining the actual intent of the Lincoln Trust Company in drafting the form on which the agreement between the treasurer and Trust Company was inserted. If that intent was other than to evidence a trust fund held by the Trust Company, knowing that its officials were aware of the limitation of

its powers under the statute under which its charter was granted, we must presume that they intended to create an ambiguous instrument by the use of which the company could enjoy the use of customers' money as an ordinary bank in spite of the statutory restrictions and at the same time show some semblance of complying with its charter powers. To the person from whom it was soliciting deposits it could say as an inducement that your money is payable at any time with interest as an ordinary bank account. To the banking commissioner or other proper parties interested the compliance with the law by institutions under supervision, the clause reciting "hold in trust" could be pointed out as an argument in support of the view that no deposits had been solicited or accepted.

We submit in view of the admitted limitation on the power of the Trust Company under Nebraska law construed in *Gamble* v. *Daniel, supra,* prohibiting it from accepting deposits, or doing a general banking business, that the transaction if not giving rise to an express trust, was illegal and the general rule above cited is applicable and that the funds deposited by the city treasurer were held by the Trust Company as trustee ex maleficio.

4.

The Circuit Court of Appeals erroneously refused to follow the construction by the Supreme Court of Nebraska of the Nebraska constitution and statute that trust funds may be recovered from an insolvent trustee upon proof that such funds augmented the assets in the hands of such trustee.

If, as we contend, a trust relation existed, then the Circuit Court of Appeals should have followed the construction of the Supreme Court of Nebraska of its Con-

stitution and statute that a cestui que trust is entitled to priority in payment from the assets of an insolvent trustee upon proof that such funds augmented such general assets.

We are concerned with the order of payment of debts of an insolvent bankrupt trust company under Section 64b of the Bankruptcy Act, which provides in Section (7) for the same priorities as exist under a state law. The bankrupt in this case was incorporated under the laws of Nebraska and in the absence of bankruptcy proceedings would be liquidated under the Nebraska laws and therefore such laws should be followed on the question of priorities. No one would seriously question the right of the City to priority under Section 64b of the Bankruptcy Act if a Nebraska statute specifically provided that a cestui que trust whose funds were mingled with and augmented the trustee's assets should be paid from the Bankrupt's assets ahead of general creditors. Such a right of priority will now be shown to exist under the Constitution and statutes of Nebraska as construed by its courts.

Section 9 of Article V of the Constitution of Nebraska, provides:

> "The district courts shall have both chancery and common law jurisdiction and such other jurisdiction as the legislature may provide; * * *."

Section 49-101 of the Compiled Statutes of Nebraska for 1929 provides:

> "**Common Law in Force.** So much of the common law of England as is applicable and not inconsistent with the Constitution of the United States, with the organic law of this state, or with any law passed or to be passed by the legislature of this state,

is adopted and declared to be law within the state of Nebraska (R. S. p. 31; Ann. 6955; Comp. 1934; R. S. 1913, 3697; C. S. 1922, 3085)."

In *Bloomfield State Bank* v. *Miller*, 55 Neb. 243, 75 N. W. 569, it is held that the statutory provision adopting the common law of England includes the law derived from the English courts of chancery.

In passing upon the distribution of assets of an insolvent trustee the Supreme Court of Nebraska has held that the Constitution of Nebraska conferred equity jurisdiction which cannot be limited by the legislature and under the equity rule which comes from the chancery practice it is only necessary to prove that the trust property augmented the assets. See *State* v. *Farmers State Bank of Polk*, 121 Neb. 532, 237 N. W. 857.

We emphasize the statement of the Supreme Court of Nebraska in the case last cited that "the rule formulated under equity power conferred by the Constitution of Nebraska and state legislation" entitled a cestui que trust to priority against the assets in the hands of a trustee upon proof that such assets have been augmented by the trust funds. **This rule has been consistently adhered to in subsequent decisions.** See *State* v. *Bank of Otoe*, 125 Neb. 383, 250 N. W. 254; *State* v. *Dwight State Bank*, 126 Neb. 687, 253 N. W. 410. This rule is not limited to banks but applies to trusts generally. See *Federal Trust Co.* v. *Baxter*, 128 Neb. —, 257 N. W. 368.

Inasmuch as it is shown without dispute that the City's money augmented the assets of the Bankrupt, "the rule formulated under equity power conferred by the Constitution of Nebraska and state legislation," as announced by its highest court, entitles the City to priority in payment from the assets now in the hands of the trustee.

Under Section 64b (7) of the Bankruptcy Act, heretofore quoted, this court should follow the decisions of the state court in allowing the City the same priority it would have received under the Nebraska Constitution and statute.

The Circuit Court of Appeals of the Eighth Circuit has recognized the applicability of the foregoing rule in *Wheeler* v. *Johnson*, 26 Fed. (2d) 455 (C. C. A. 8).

Under the express provisions of Section 64b of the Bankruptcy Act and the holding of the foregoing case, the court should have followed the construction placed by the Nebraska court on its constitution and statute and allow full priority to petitioners' claim.

But even if priority is not allowed under Section 64b it should be granted to the extent such funds passed into the hands of the trustee in bankruptcy under the ordinary equitable principles for administering trust funds as determined by the Nebraska courts based on its constitution and statute in the cases previously cited under this heading.

"The rule formulated under equity power conferred by the Constitution of Nebraska and state legislation" as announced in *State* v. *Farmers State Bank of Polk*, *supra*, entitles a cestui que trust to priority in payment of its claim upon proof that the assets in the hands of the trustee were augmented by the trust funds. All of the decisions there referred to, recognize that the title to the funds of the cestui que trust, even though mingled with other funds, does not pass to the trustee in bankruptcy but remains the property of the cestui que trust. Notwithstanding the fact that it is impossible to prove that any part thereof passed into the possession of the

trustee in bankruptcy, it becomes a charge on the property for the amount such funds augmented the assets which passed to the trustee in bankruptcy. In some instances it has been recognized as a lien on the property but whether considered as a charge or a lien the rule is definitely established in Nebraska that the cestui que trust is entitled to be paid from the assets before the general creditors. Even if it does not entitle the City to priority under Section 64b of the Bankruptcy Act it does establish a rule of equity in Nebraska for the administration of trust funds based on its constitution and statute which should be followed by this court.

The District Court in its last memorandum cites *Mandel* v. *Burton*, 292 Fed. 127 (C. C. A. 8), as holding that the state rule relating to trust funds will not be followed in bankruptcy proceedings. In that case the court says at page 129:

> "Appellants present their theory of following the fund as a trust fund under the Missouri decisions. The question does not involve any **rule of property** or the **construction** of **a state statute,** but merely a **principle of equity.** Hence the federal decisions must govern."

However, the foregoing case does not hold against our contention, but in effect supports our position. It holds the federal decisions must govern because the construction of a state statute is NOT involved. The corrollary would be that if the construction of a state statute IS involved then state decisions must govern. That is exactly the question presented in the case now before the court. Shall this court follow the construction placed on the Nebraska Constitution and statute by its court? If it does, then the City is entitled to priority for the full amount of its claim.

In the recent case of *Burns Mortg. Co.* v. *Fried*, 292 U. S. 487, it was held that the federal court must adhere to the state court's construction of a law even though such law only purports to be declaratory of the common law.

In *Marine National Exchange Bank* v. *Kalt-Zimmers*, 293 U. S. 540, the same rule is followed in bankruptcy proceedings. In the opinion the court says:

> "An identical provision was considered by the Supreme Court of Wisconsin in *Pollard* v. *Tobin*, 211 Wis. 405, 247 N. W. 453. The ruling of the court was that negotiability was not impaired. (Cases cited.) * * * This construction of a Wisconsin statute is binding upon the national courts, though the statute may have intended to be declaratory of the rule at common law. *Burns Mortg. Co.* v. *Fried*, 292 U. S. 487, 78 L. Ed. 1380, 54 S. Ct. 812, 92 A. L. R. 1193."

It would seem that the rule announced in the foregoing cases should be applicable whether the state court construes a statute declaratory of the common law or whether the state court construes a statute adopting the common law. There is no difference in principle whether a statute declares the common law rule as to recovering trust funds and the court then construes the rule thus announced or whether the statute adopts the common law and the court then construes the common law thus adopted to include a rule for the administration of trust funds.

We respectfully submit that the construction placed on the common law rule formulated under the power conferred on its courts by the Nebraska Constitution and

the construction placed on the common law rule adopted by the Nebraska statute should have been followed by the Circuit Court of Appeals.

CONCLUSION.

The questions involved in this case are of far reaching importance. One obvious effect of the decision is to place a narrow and unjustified construction on the Bankruptcy Act in denying a municipal corporation the same priority as any other corporation would be entitled to receive. Furthermore, the duty of the federal courts to follow the rule formulated under the constitution and statutes of a state relating to trust funds should be definitely established by a decision of this court.

CITY OF LINCOLN, NEBRASKA, AND STANDARD ACCIDENT INSURANCE COMPANY,
Petitioners,

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